The Fed Must Do More To Help the Economy

Joseph Gagnon explains why and how the Federal Reserve, along with other central banks, can take further steps to encourage bank lending and reduce unemployment.

Edited transcript, recorded December 15, 2009. *© Peterson Institute for International Economics.*

Steve Weisman: Is the federal government doing enough to stimulate the national economy and are the world's treasuries and central banks doing enough?

This is Steve Weisman at the Peterson Institute for International Economics. To help answer that question, our guest today, Joseph Gagnon, senior fellow at the Institute, will talk about his proposals that have generated quite a lot of publicity about what the Fed and other central banks can do.

Thank you, Joseph.

Joseph Gagnon: Thanks, Steve. Good to be here.

Steve Weisman: You've written a policy brief at the Institute that's generated a huge amount of attention. Paul Krugman devoted a column to it in the New York Times. What should the Fed to do to help push the economy out of its downturn?

Joseph Gagnon: What I would like the Fed to do is actually more of what it has been doing. It acted very aggressively starting about a year ago and especially last spring to try to push interest rates down. Not only the short-term rates that they traditionally control but when those hit zero—and you can't have them go below zero, which is a topic for another day—they try to push longer-term interest rates down. In particular, they focused a lot on the mortgage market and tried to get mortgage rates down for homeowners across the country. And they were very successful. They pushed, by my estimates, homeowners' mortgage rates down about 1.25 percentage points relative to where they would have been. And they have stayed down pretty much since late last year.

But they're about to finish their planned purchases of these assets and there's a fear that interest rates could rise when, in fact, I think they should actually be a bit more aggressive. I think they should actually do more of this because it's been quite successful and if anything, it would be good to have even a bit further decline in long-term interest rates.

Steve Weisman: What exactly is entailed by this sort of Fed action and purchase of mortgage-backed securities or other instruments?

Joseph Gagnon: Traditionally the Fed, we know it prints money, but basically at the margin for most of its activities. When it buys an asset, it credits the bank of the owner of that asset

with a claim on the Federal Reserve, called a bank reserve. So it increases the volume of bank reserves—that's printing money in this context. So banks are given reserves of the Federal Reserve, and the Federal Reserve gets the asset it buys. And what it has been buying lately, these big programs, has been mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac and Ginnie Mae—the government-sponsored enterprises—mortgage-backed securities guaranteed by these agencies as well as longer-term Treasury bonds. And I think they should continue that and perhaps move more toward treasuries because they've already bought a lot of the MBS, but they continue buying the MBS.

Steve Weisman: MBS is?

Joseph Gagnon: MBS is mortgage-backed securities. When you get a loan on your house from a bank, typically, especially if it's a conforming mortgage—meeting the criterion for Fannie Mae and Freddie Mac—that is packaged with other mortgages into what is called a mortgage-backed security, or MBS, which is a pool of mortgages. Maybe several hundred mortgages that are sold to investors and the principal interest on these are guaranteed by the housing agency.

So they're very safe assets and it's not exposing the Fed to a significant amount of credit risk. But it is helping to drive down the rate that people pay on their mortgages by giving the mortgage [units] of banks a ready market to sell these loans.

Steve Weisman: You mentioned that the effect of this is to print money. Is that literally true? Or is it just that it results in banks having higher levels of reserves and therefore more liquidity and more ability to make loans?

Joseph Gagnon: Yes. It is not literally printing currency. For the most part, it is what you said. The customers who are selling the mortgage-backed securities, whoever is selling them to the Fed, basically get their bank account credited if they get money on deposit at their bank, and their bank in turn gets credited with reserves at the Federal Reserve, which pay a rate of interest roughly the same as Treasury bills right now. So it's 25 basis points, that's one-quarter of one percentage point.

And so it's a very low interest rate but people want these. There's been a higher demand throughout, and after the financial crisis, for very safe short-term assets. People have readily been wanting to hold bank deposits even if they pay lowered rates of interest and in turn, the banks are happy to hold these liquid Federal Reserve assets.

Steve Weisman: This week President Obama had a dozen banking executives in and he implored them to make more loans. Is imploring enough?

Joseph Gagnon: With interest rates at zero, the way monetary policy works is somewhat different from before. In normal times, when you supplied bank reserves, banks normally don't want to hold much [in] reserves. Usually they traditionally had paid zero interest and interest rates were high so they wanted to basically use them to make loans right away and that was the money multiplier. That was sort of the way monetary policy expanded the economy through the bank loans.

But this is a different animal. At this point with all short-term interest rates very low, close to zero, banks don't mind holding reserves. They're less inclined to lend them out than before, although hopefully they will. But that's okay. I mean it's better if they were lending it but because the Federal Reserve is buying in large quantities. This is why this policy has to be done in a much larger scale than before.

The Federal Reserve has bought $1.7 trillion of these assets and I'm proposing that in the coming year, they buy another $2 trillion of these assets. And that's a large amount, much larger than normal monetary policy would operate in. The Federal Reserve is effectively doing the lending that we wish the banks were doing, and if the banks would start doing it again, the Federal Reserve could get out of that business. But for now, I'm proposing the Federal Reserve effectively do that lending.

Steve Weisman: Of course, the Federal Reserve is in the midst of Congress revising the statute that would define the Fed's powers. Wouldn't the Fed doing this alarm some of those in Congress who worry about inflation, worry about overexpansion of money supply, overaggressive action by the Fed without supervision or accountability? As a practical political matter, wouldn't this be risky for the Fed to do?

Joseph Gagnon: That is a view held out there. I guess I take the opposite view. I think it's actually risky for them not to do this because they have been instructed in law, by law, to go for stable prices and maximum employment. Clearly, they are failing on the maximum employment objective and even their own forecast doesn't predict that they will get back to what they view as maximum employment for many years. So they need to do more to achieve that objective. That's a mandated objective in the law.

Second, they have stated that their view of stable prices is an inflation rate of about two percentage points. For various reasons, actually you don't want to have zero. It's actually better to have a small positive number of two. That's generally agreed around the world; it's not unique to the United States. So they are failing on that objective, too, because the current inflation rate is below two. And I believe it's a significant risk that it will go farther below two.

So again, they need to do more to achieve the mandated objectives in the law as it currently is written. It seems to me if they don't do what Congress asks them to do, they will be in political trouble.

Steve Weisman: Let me take this into a global context because you've recommended that the leading industrial centers adopt similar policies, especially Europe and Japan. What would they do to carry out such a policy? Do they have the same tools?

Joseph Gagnon: Yes, they have the same tools. In fact, they have more tools. The central banks in Europe and Japan actually have greater powers in terms of what they can buy than the Federal Reserve has.

The Bank of Japan is allowed to buy equities in Japan, for example. It may have, which is not something the Federal Reserve is allowed to do. And of course, the Bank of Japan can do the things the Federal Reserve can do to buy government bonds and to buy high grade. They're not the large housing agencies in Japan, but

they can actually buy corporate bonds in Japan. Again, the Federal Reserve cannot buy corporate bonds directly.

Steve Weisman: What about Europe?

Joseph Gagnon: I'm not sure of the ECB, whether they can buy equity but they can buy—

Steve Weisman: The ECB is the European Central Bank.

Joseph Gagnon: Yes, the way that they can buy equity [is] the way Bank of Japan can. But they can buy government and corporate bonds. And both the European Central Bank and the Bank of Japan are doing these policies in a very, very small scale. So I am encouraging them to greatly step up the rate at which they do this.

Steve Weisman: And the Bank of England?

Joseph Gagnon: The Bank of England is actually in a similar position to the Federal Reserve. It has been buying, relative to size of its economy, a lot of government bonds in the United Kingdom. I recommend that they continue to do that, similar to what I recommend for the United States.

Steve Weisman: Finally, Joe, there's talk in Washington about an exit strategy from the easy monetary and fiscal policies of the last year. You're concerned that we might be heading prematurely for the exit.

Joseph Gagnon: Yes, absolutely. I think there's too much talk of exit.

I understand that there is concern about that down the road, if these large expansions of central bank balance sheets don't reverse or have alternate policies that can unwind them through higher interest rates, that we could overdo it, we could overstimulate the economy and get inflation. That's a risk. It's not in anyone's forecast now—or almost no one's forecast now. The overwhelming consensus of the latest forecast is for economic weakness and no rise in inflation. And if anything, I think the most plausible forecasts have inflation falling.

But at some point, people are worried that central banks won't turn around, reverse course quickly enough when they need to. I think that is a risk for the future that we should be mindful of, but it's not the need right now. We need now more policy ease and we shouldn't make the mistake now because we're afraid of making a different mistake later. It seems to me to worry about making the mistake later should not cause you to make a different mistake now. But what's needed now is more stimulus. Later we'll need to withdraw it, but I believe that won't be for at least two more years and possibly longer. But I hope sooner, if we get the right action.

Steve Weisman: Joseph Gagnon, thank you very much for walking us through your very interesting policy position and good luck with it.

Joseph Gagnon: You're welcome, Steve.